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Regulatory Issues in Creating a Single Insurance Market

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The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

This report responds to your request for information on insurance regulation in the European Community (EC). The increasing globalization of the U.S. insurance industry has heightened the need to understand the regulatory systems of foreign insurance markets, such as that of the EC. Collectively, insurance markets of the EC member states[1] accounted for approximately $363 billion, or over one-quarter, of all insurance premiums collected worldwide in 1990. An integrated EC insurance market would thus rank as the world's second largest after that of the United States.[2] This review (1) describes the framework of insurance regulation developed by the EC to create a single insurance market and (2) identifies regulatory issues concerning the development and implementation of this framework.

To develop this information, we reviewed existing studies on the EC framework of insurance regulation; evaluated EC insurance legislation; and discussed issues concerning the EC framework of insurance regulation with regulators, supervisors, industry representatives, and market analysts in the EC and the four largest EC member states of France, Germany, Italy, and the United Kingdom. For more detailed information about our objectives, scope, and methodology, see appendix VII.

We did our work from March 1992 to December 1992 in accordance with generally accepted government auditing standards.

Background

Since 1957, the EC has been striving to create a single economic market among its member states. To hasten the creation of this market, the EC

[1]The 12 EC member states are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

[2]In 1993, the EC and the seven countries of the European Free Trade Association (EFTA)—Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland—are scheduled to create a larger combined free-trade zone called the European Economic Area (EEA). However, according to EC officials, Switzerland's rejection of the EEA agreement on December 6, 1992, will postpone the agreement's entering into force by 6 months. In total, the insurance markets of the countries that will constitute the EEA accounted for approximately $417 billion, or almost 31 percent, of all premiums collected worldwide in 1990.

launched a single market program in 1985 to dismantle remaining barriers to the unrestricted movement of people, capital, goods, and services among its member states. The EC expects the elimination of such barriers to promote competition, thereby benefiting both producers and consumers. As planned, the EC had largely completed its legislative framework for the single market by the end of 1992. Although incomplete in some areas, this framework already allows for the freer movement of people, capital, goods, and services in the EC. The EC has also made significant progress toward creating a single market in the insurance industry. Large parts of the framework for the single insurance market are already in place, increasing access by insurers to some parts of the EC-wide market. When completely operational, the single insurance market is expected to provide insurance companies with complete market access throughout the EC and to offer consumers a wider selection of insurance products at more competitive prices.

The EC is implementing its single market program through the harmonization and mutual recognition of regulatory standards among the member states. Under harmonization, the EC reduces regulatory disparities among the member states by establishing common minimum regulatory standards. In turn, the harmonization of standards allows member states to recognize each other's regulatory and supervisory systems. Although member states must adopt EC standards, they retain responsibility for supervising their national markets and generally maintain some discretion over how they implement these standards. The EC is harmonizing only those areas of regulation that it considers essential for the creation of a single market. In other areas, member states have agreed to recognize each other's regulatory standards, which continue to differ.

Results in Brief

The EC has developed a framework of insurance regulation for its member states in order to create a single insurance market. However, the framework's final provisions will not be implemented by the member states until 1994. Among these are key provisions relating to the financial supervision of an insurance company throughout the EC by a single member state.

Although the EC has already adopted the key elements of its framework of insurance regulation as envisioned under the single market program, three groups of regulatory issues remain. We think these issues may require additional attention as the single market becomes a reality. The first group involves a number of topics that EC officials acknowledge still need to be addressed. In contrast, the EC considers the second group, involving continuing regulatory differences among the member states, to be sufficiently addressed by existing member state or EC mechanisms. Finally, a third set of issues reflects uncertainties about how some elements of the system of insurance regulation adopted by the EC will work when fully implemented by the member states.

EC Framework for Insurance Regulation

Under its framework of insurance regulation, the EC will allow an insurance company based in any member state to provide services throughout the EC using a single license from this member state (its home state). To ensure adequate supervision of the entire insurance company, the home state will have sole responsibility for the financial supervision of the insurance company's operations throughout the EC. Specifically, the home state must monitor the insurance company's compliance with "minimum prudential standards" of financial soundness. These standards require the insurance company to maintain a sufficient level and mix of assets to pay policyholder claims and to remain solvent.

To implement its framework of insurance regulation, the EC has adopted 21 legislative directives on insurance since 1964. These directives harmonize key areas of insurance regulation within the EC by introducing minimum regulatory standards that member states must incorporate into their national regulatory systems. Member states must implement a directive within a specified time frame, usually within 2 years of the directive's adoption by the EC. However, certain directives give some member states, particularly the newest member states, additional time to implement specific provisions. According to EC officials, virtually all member states have been implementing the directives within required time frames.

The EC adopted two major insurance directives in 1992 that introduce key aspects of the EC framework of insurance regulation. Member states are not required to implement these directives until 1994.

Regulatory Issues Remaining

Three groups of regulatory issues may require additional attention as the single insurance market becomes fully implemented. EC officials, while stating that issues in the first group need not be resolved in order to establish the single market, still recognize their importance. As a result, additional regulatory measures to address these issues are being considered. For example, the EC has proposed a directive to ensure the equal treatment of creditors and policyholders from any member state when an insurance company is liquidated. The EC has also issued a recommendation to establish minimum qualifications for insurance agents and brokers. In addition, EC officials acknowledge the need to reassess the adequacy of the current minimum prudential standards and to review the problems associated with the supervision of financial conglomerates.

The second group of issues is associated with continuing regulatory differences among the member states that the EC has no plans to harmonize. These differences involve taxation, contract laws, valuation methods for assets and liabilities, supervisory reporting of financial and nonfinancial information, and antifraud measures. EC officials contend that these areas do not require harmonization and are sufficiently addressed by existing EC or member state mechanisms. However, prior attempts by the EC to harmonize some of these regulatory differences were abandoned because they proved too complicated or difficult to negotiate among the member states. According to some insurance industry representatives and market analysts with whom we spoke or whose publications we reviewed, including the former head of the EC Commission's Insurance Division, the absence of harmonization in some of these areas could undermine some objectives of the single insurance market.

The third set of issues reflects uncertainties over how some elements of the EC system of insurance regulation will work when fully implemented. These issues, which pertain to various provisions of the system that are not scheduled to be implemented by the member states until 1994, include the EC-wide financial supervision of insurance companies by home states based on minimum prudential standards; the level of cooperation required among member state authorities; the resources and expertise available to member state supervisors; the criteria for a member state to take regulatory action against an insurance company based in another member state; the definition of "insolvency"; and the financial effects of competition on insurance companies in the single market.

To address some of the uncertainties involved in this third group of issues, the EC and various member states have developed, or are considering, various regulatory and supervisory mechanisms. For example, the EC has established an early warning system to enhance the home state's financial supervision of life insurance companies. Under the system, supervisors in other member states must notify a life insurance company's home state supervisor if they suspect that the company is experiencing financial difficulties. To foster cooperation and information sharing, member state supervisors have jointly developed protocols on the practical implementation of EC directives, while the EC has established an Insurance Advisory Committee. This Committee is composed of representatives from member state insurance supervisors and the EC. In addition, the EC intends to use the European Court of Justice to resolve conflicts over the interpretation of EC criteria for supervisory intervention.

More detailed information about the issues raised in this letter can be found in the attached appendixes. Appendix I describes the EC's move toward a single market in insurance and amplifies the three sets of regulatory issues laid out in this letter. Appendix II provides additional general background on the EC. Appendix III discusses the size and importance of insurance markets in the EC member states. Appendixes IV and V explain the minimum prudential standards that form the basis of EC insurance regulation. Appendix VI summarizes the content and status of all EC insurance directives.

EC Commission Comments

We discussed the contents of this report with officials from the EC Commission in Brussels, who provided detailed written comments, both general and technical, on a draft of this report. These comments and our response are in appendix VIII. In its letter, the Commission stated that it found "an implicit premise running through the report that anything short of totally harmonized standards at EC level does or will create 'uncertainties' and problems." We disagree with this finding because the report makes no conclusions linking the absence of complete regulatory harmonization to regulatory problems. As stated on page 1 of the report, our objectives were to describe the EC's framework of insurance regulation and to identify regulatory issues concerning the development of this framework. The report identifies issues discussed by insurance regulators, supervisors, companies, and market analysts in the various EC member states we visited. As the Commission acknowledged on pages 1 and 2 of its letter (pages 47 and 48), "it is only logical that regulators and market participants in those countries voice some concern in view of the changes in the regulatory and competitive environment" brought about by the EC's framework.

We also disagree with the Commission's statement that the EC's "important effort to deregulate insurance markets . . . receives practically no attention" in our report. The EC's single market program and goals for a single insurance market, including its potential benefits for insurance companies, constitute the premise of our report and are described in some detail on pages 12 and 13. As the report's title indicates, however, the report focuses on regulatory issues, rather than market developments, associated with the EC's creation of a single insurance market. In addition, we disagree with the EC's statement that "the report concentrates on perceived 'uncertainties' over elements of the EC system." Only one of the three groups of regulatory issues in the report involves uncertainties over elements of the EC framework of insurance regulation. Furthermore, for each uncertainty identified in this group, the report describes the positive measures being taken or considered by the EC and the member states in response to the uncertainty. Our categorization of regulatory issues into the three groups does not constitute "conclusions" about the EC's framework. Rather, it is intended to help a reader of our report better understand the nature of the issues we are discussing and how such issues are being addressed.

We are sending copies of this report to the EC Commission, insurance regulators and supervisors in several European countries, and the National Association of Insurance Commissioners in the United States. Copies will be made available to others on request.

Please call me at (202) 512-8678 if you have any questions concerning the report. Major contributors to this report are listed in appendix IX.

Sincerely yours,

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

EC	European Community
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EMS	European Monetary System
OECD	Organization for Economic Cooperation and Development

Regulatory Issues in Creating a Single European Insurance Market

Since its founding in 1957, the EC has been striving to create an integrated economic market among its member states. Although the EC initially hoped to create the single market relatively rapidly, economic recessions and continuing protectionism among the member states impeded the EC's initial attempts at integration.

The EC launched a program in 1985 to accelerate the creation of the single market. Under the program, the EC sought to dismantle the remaining barriers to the unrestricted movement of people, capital, goods, and services among its member states by the end of 1992. Even though this goal was not entirely met, the EC's single market framework, generally and for insurance, is substantially in place, and progress continues toward full implementation and removal of remaining barriers to trade. The elimination of such barriers is expected to promote competition in a single market, thereby benefiting both producers and consumers.

For the financial services, the EC is using an approach based on the harmonization and mutual recognition of member state regulatory systems to implement the single market program.[1] Through harmonization, the EC establishes common minimum regulatory standards where deemed essential to protect the public interest and to create a single market. Harmonization is intended to aid the convergence of member state regulations. However, market forces are also expected to reduce regulatory disparities among the member states. Member states must adopt the EC's harmonized standards and open their markets. However, they will continue to regulate their individual national markets, although individual companies will be financially supervised by their home state no matter where they do business. In addition, member states generally have some discretion over how they implement the EC's minimum standards.

In turn, harmonization allows for the mutual recognition of regulations and supervision among the member states. By adopting the same minimum standards throughout the EC, member states are able to recognize the adequacy of each other's regulatory and supervisory systems, although such systems may continue to differ in certain areas.

[1]Before the single market program, the EC attempted to achieve greater uniformity of standards among member states through detailed legislative harmonization. Because these efforts proved lengthy and complex, the EC adopted its current approach.

Framework of Insurance Regulation Developed to Create a Single Insurance Market

The EC has developed a framework of insurance regulation to create a single insurance market among its member states. A single insurance market is expected to promote competition among insurance companies and offer consumers a wider selection of insurance products at more competitive prices. According to a study commissioned by the EC,[2] market integration within the EC's three financial services sectors—banking, securities, and insurance—could eventually result in economic gains of approximately European Currency Unit (ECU) 22 billion ($26 billion).[3]

To foster competition in the insurance industry, the EC framework of insurance regulation allows an insurance company based in any member state to operate freely throughout the EC, either through freedom of establishment or freedom to provide cross-border services. Under freedom of establishment, an insurance company based in any member state may establish branches in other member states. Alternatively, freedom to provide cross-border services enables an insurance company to serve consumers in other member states directly without being established in those states. According to EC officials, EC insurance companies already seem to be anticipating a single EC insurance market. These officials stated that a large number of EC insurance companies have provided notification of their intention to conduct business in other member states and are increasingly involved in cross-border mergers.

Principles of EC Insurance Regulation Include Single Licensing, Home State Control, and Minimum Prudential Standards

The EC framework of insurance regulation is designed to ensure that insurance companies can compete freely in a single EC-wide insurance market while maintaining an adequate level of financial soundness. The framework parallels the EC's approach to the other financial services. The EC has already established a similar framework for banking and has taken a common position for the adoption of a similar framework for investment services by 1996.

Under the framework, an insurance company may establish branches or provide cross-border services throughout the EC using a single license from the member state in which it is based.[4] This state, called the insurance company's home member state (home state), is solely responsible for the

[2]In 1988, the EC Commission summarized the results of research on the costs of market fragmentation within the EC in a report written by Paolo Cecchini entitled The European Challenge 1992: The Benefits of a Single Market. This report is also referred to as the Cecchini Report.

[3]An ECU is an accounting unit of currency based on the values of the individual currencies of the member states. As of December 31, 1992, ECU 1.00 equaled approximately $1.20.

[4]The single license is also referred to as the "single passport."

financial supervision of the company's operations in all member states (home state control).

In fulfilling its supervisory responsibilities, the home state ensures that the insurance company complies with minimum standards of financial soundness (minimum prudential standards) established by the EC.[5] A member state may impose more stringent prudential standards, but only on its own domestically based insurance companies. In addition, member states will no longer be able to require any insurance company selling in their market to obtain prior regulatory approvals of premium levels and policy conditions.

While a home state supervises an insurance company's financial operations throughout the EC, another member state where the company provides services (host state) may take some regulatory actions against the insurance company under certain circumstances. For example, a host state may prohibit the sale of an insurance contract by an insurance company licensed and supervised by another member state if the contract conflicts with the host state's legal provisions protecting consumers.

EC Is Implementing Insurance Regulation Primarily Through Legislative Directives

The EC is implementing its framework of insurance regulation through legislative directives that are agreed to by the member states.[6] These directives harmonize key areas of insurance regulation among the member states by introducing EC-wide regulatory standards and practices. Once directives are adopted by the EC, their provisions must be incorporated by the member states into their national regulatory systems within specified time frames, ranging from a few months to a few years. However, certain directives give some member states, particularly the newest member states, additional time to implement specific provisions of the directives. According to EC officials, virtually all member states have implemented the existing directives within specified time frames. (App. VI shows the status of insurance directives adopted or currently being considered by the EC.)

The EC has adopted 21 directives on insurance regulation since 1964. In the 1970s, the EC issued directives that set the current minimum prudential

[5]See appendix IV for detailed descriptions of the EC's minimum prudential standards.

[6]Most measures in the EC's single market program, including those concerning insurance, are approved by the 12 member states under a system of qualified majority voting. Under this system, each member state receives a different number of votes, ranging from 2 to 10, according to its size. To be approved, an EC measure must receive at least 54 of the total 76 votes cast by the 12 member states. However, the EC still requires unanimity among the member states for measures concerning taxation, the free movement of persons, the environment, and the rights and interests of employees.

standards for insurance companies and allowed insurance companies to establish branches in all member states.

Under the single market program, the EC has completed its regulatory framework for a single insurance market. In 1988 and 1990, the EC issued directives that permit insurance companies to offer limited cross-border services directly to consumers in other member states. In 1992, the EC adopted additional directives that member states must implement by 1994 to eliminate the remaining restrictions on providing cross-border services, introduce single licensing, implement home state control over financial supervision, and prohibit requirements for the prior approval of premiums and policy conditions.

Regulatory Issues Remain Concerning Development of EC Insurance Regulation

Although the EC has already adopted the key elements of its framework of insurance regulation as envisioned under the single market program, three groups of regulatory issues remain concerning the framework and its implementation. These issues may require additional attention before the ultimate success of the single insurance market can be known. Each group is discussed separately in detail in the following three sections of this appendix.

The first group includes several issues that EC officials acknowledge still need to be addressed, such as the supervision of financial conglomerates. The EC has proposed or is considering regulatory mechanisms to handle the issues in this group.

The second group of issues involves continuing regulatory differences among the member states, which the EC has no plans to harmonize. EC officials stated that these areas do not require harmonization and are sufficiently addressed by existing EC or member state mechanisms.

The third set of issues reflects uncertainties over how some elements of the EC framework of insurance regulation that have been adopted by the EC will work when fully implemented by the member states. For example, systems for EC-wide financial supervision of insurers and for cooperation among insurance regulators have not yet been fully tested. In some cases, however, the EC and the member states have developed or are considering measures to address these uncertainties.

Issues to Be Addressed

Although the EC has already adopted all the directives that it considers essential for creating a single insurance market, it is discussing additional measures to address some emerging regulatory issues. For example, the EC has proposed a directive to establish common procedures for member states to dissolve and liquidate an insurance company if it loses its authorization to conduct business or becomes insolvent. The principal objective of this proposal is to ensure that all creditors and policyholders of an insurance company, wherever situated in the EC, receive equal treatment under such circumstances. In cases of insolvency, the proposal would require an insurance company to create a separate asset fund corresponding to its technical reserves to guarantee the claims of its policyholders and reinsurance companies. Although this directive was proposed by the EC in 1989, it had still not been adopted as of December 1992. According to EC officials, the proposal is now under negotiation within the EC Council of Ministers.

The EC may also consider a second directive on insurance intermediaries (agents and brokers). The EC adopted its first directive on intermediaries in 1976, allowing them to establish offices and provide cross-border services throughout the EC. However, this directive did not harmonize member state regulations concerning the supervision of intermediaries. Consequently, the EC issued a recommendation in 1992 providing for minimum qualifications for intermediaries, definitions of independent intermediaries, and compulsory registration of intermediaries. Although the recommendation is nonbinding on the member states, its aim is to establish guidelines for those member states that may not have adequate regulations in these areas. According to EC officials, the EC opted to issue a recommendation rather than adopt a directive on intermediaries because such a directive would have conflicted with another recently adopted directive on life insurance. This latter directive gives member states until 1996 to adopt national standards on the qualifications and independence of insurance intermediaries. However, depending on whether member states establish the requirements for intermediaries suggested in the recommendation by 1994, the EC intends to consider another directive on intermediaries in the future.

The EC is also considering other regulatory issues for which it has not yet introduced concrete proposals. For example, EC officials intend to review the appropriateness of the current minimum prudential standards in light of changes in insurance markets since the standards were first established in the 1970s. EC officials recognize that the minimum required levels for these standards, which have not been revised since they were first introduced, may now be too low. Consequently, two directives adopted by the EC in 1992 will require a reassessment of the current solvency margin requirements within 3 years of their application. According to EC officials, however, some member states already tend to require higher levels of solvency margins from insurance companies than those established by the EC.[7] For example, officials of the United Kingdom's (U.K.) Department of Trade and Industry acknowledge that they would become concerned and may begin informal dialogue with an insurance company if its solvency margin fell to a level twice as high as that required by the EC. In contrast, Italian officials said that they would not take regulatory action against an insurance company unless its solvency margin fell below the EC's required level.

The EC is also considering ways to address the problems associated with the supervision of financial conglomerates, which are groups of companies from one or more of the financial services sectors—banking, investment services, and insurance—with common ownership. The supervision of a financial conglomerate can be complicated because the group's companies may be supervised by different competent authorities either within the same member state or in different member states. The EC is particularly concerned about the potential for "double leveraging" and "contagion" within financial conglomerates. In double leveraging, different companies within a financial conglomerate use the same assets to meet separate prudential requirements. Through contagion, some companies of a financial conglomerate become exposed to the financial problems or loss of market confidence affecting another company of the group. Similarly, these problems could also affect the growing number of "bancassurance" or "allfinanz" arrangements—financial and operational links between banks and insurance companies—in the EC. One EC official estimates that approximately 200 such bancassurance arrangements currently exist in the EC.

According to EC officials, member state insurance supervisors have not yet reached consensus regarding the supervision of financial conglomerates involving insurance companies. However, according to the EC Commission's Director General for Financial Services, the EC's general approach to the supervision of financial conglomerates involves the acceptance of market trends toward despecialization in the financial services; the suggested adoption of special rules involving consolidated

[7]According to the member state supervisors we interviewed, most insurance companies they supervise maintain solvency margins that far exceed the EC's minimum requirements. However, we could not verify these claims because we were unable to obtain the necessary statistical information from these supervisory authorities.

supervision only where regulatory problems cannot be tackled effectively through supervision on a solo basis;[8] and respect for the different philosophies and methods of banking, securities, and insurance supervisors. According to EC officials, the EC Commission and Insurance Advisory Committee also intend to coordinate their efforts with those of other international regulatory and supervisory organizations.[9]

Although the EC has not yet formulated a specific approach toward the supervision of financial conglomerates involving insurance companies, it has already adopted measures concerning the supervision of conglomerates consisting primarily of banks or securities firms. For example, the EC recently adopted a directive on the consolidated supervision of financial conglomerates with one or more banks. The directive requires the consolidated supervision of all companies within such conglomerates, which may be headed by banks or financial holding companies. This directive obliges the supervisors of companies from different financial sectors in such a conglomerate to cooperate and exchange information. It also generally assigns responsibility for consolidated supervision to the authorities of the member state that regulates the conglomerate's only bank or its largest bank.

Issues for Which Harmonization Will Not Be Considered

Although the EC has harmonized some areas of insurance regulation, it does not intend to harmonize other areas that continue to differ among the member states. These areas include taxation, contract laws, asset valuation methods, supervisory reporting requirements, and antifraud measures. According to EC officials, these areas are adequately addressed by existing member state or EC provisions. In some of these areas, however, prior attempts by the EC at harmonization proved too complicated or difficult to negotiate among the member states. Furthermore, although EC officials stated that these areas do not require harmonization, most insurance industry representatives and market analysts we interviewed in the EC believe that the absence of harmonization in some of these areas could undermine certain objectives of the single insurance market.

[8]Under consolidated supervision, a single competent authority would monitor the overall financial position of a financial conglomerate, which would be required to account for the financial activities of all its entities.

[9]These organizations include the Conference of EC Insurance Supervisors, the International Organization of Securities Commissions, and the Basel Group of Banking Supervisors.

Taxation

The EC subjects insurance premiums to taxes levied by the member state in which the risk associated with a specific policy is located. In most cases, this member state would be that of the policyholder. Fiscal policies regarding insurance policies, however, differ widely among the member states. For example, while insurance premiums in the U.K. are not taxed, premium taxes in France range from 7 to 30 percent depending on the type of risk insured. In addition, corporate tax rates imposed on insurance companies also differ among the member states.

The EC had previously considered the need for harmonizing insurance taxes among the member states. According to EC officials, however, the EC has since decided to rely on market forces in the single insurance market to reduce tax disparities. Furthermore, according to these officials, consensus among the member states, which is required under the single market program to harmonize fiscal policies, has been difficult to achieve in this area.

According to several insurance industry representatives and market analysts, including the former head of the EC Commission's Insurance Division, continuing discrepancies among member state tax regimes could distort competition in a single insurance market. A wide variation in policies regarding insurance premium taxes, corporate taxes, and the tax treatment of employment benefits continues to exist among member states. Such variation amplifies the impact of the discriminatory practice among some member states of granting tax relief for certain premium payments only to domestically based insurance companies. For instance, a Belgian tax law prevents Belgian taxpayers from deducting premiums paid for certain lines of life insurance from their income tax unless such premiums were paid to Belgian insurance companies. Arguing that the law discriminated against insurance companies based in other member states, the EC Commission challenged Belgium in the European Court of Justice. In 1992, however, the Court ruled that, in the absence of tax harmonization in the EC, the Belgian law was necessary to protect the integrity of Belgium's fiscal system.

Contract Laws

The EC has instituted rules for determining which member state's laws—those of the state of the policyholder or the state of the insurance company—should govern an insurance contract. To protect consumers, the EC generally subjects insurance policies to the laws of the member state in which the policyholder resides. However, member states may also allow the parties in an insurance contract to agree on applying the laws of another member state to govern the contract. In addition, once certain directives adopted by the EC in 1992 are implemented by the member states, insurance policies will no longer be subject to prior regulatory approval, as currently required for some policies by some member states, including France, Germany, and Italy.

In 1979, the EC proposed a detailed directive to harmonize member state laws and regulations relating to nonlife insurance contracts. However, this proposal has made little progress, and the EC has since decided that the harmonization of insurance contract laws or policy conditions is unnecessary. Furthermore, according to the EC, adequate provisions exist in its framework of insurance regulation for the member states to protect consumers.

Asset Valuation Methods

In 1991, the EC adopted a directive to harmonize member state requirements regarding the publication of annual and consolidated accounts of insurance companies (the accounts directive). Through this directive, the EC aims to ensure that public financial information about an insurance company based in any member state is available in a standard format to potential customers, shareholders, and financial advisors. Specifically, the accounts directive introduces a common structure and content for the annual financial statements (balance sheets and profit and loss statements) of insurance companies in all member states.

Traditionally, accounting conventions among the member states have varied, including rules for valuing investments. For example, some member states, such as France, Germany, and Italy, generally require companies to calculate investments at their original purchase price. In contrast, the U.K. requires companies to assess investments at current market values. Despite the efforts of the EC to address such differences among the member states, some of the regulators and supervisors in the member states we visited expressed satisfaction with their respective accounting systems.

Consequently, the EC has not harmonized the valuation methods or the fundamental accounting principles of the member states in the accounts directive. Instead, the accounts directive will eventually require insurance companies to assess their investments in their financial statements based on both purchase price and current value. For example, if an insurance company calculates the value of an investment in its balance sheet based on the original purchase price, it will also have to disclose the current value of the investment in the notes to the balance sheet.

Although the accounts directive aims to promote uniformity in the presentation of financial information by insurance companies, the EC still leaves member states with some discretion over the valuation of assets and liabilities. According to some industry analysts, the lack of more detailed harmonization in this area will result in different accounting policies for valuing similar assets and liabilities. In turn, these analysts expect such differences to hamper comparisons of the performance and financial strength of insurance companies based in different member states. In particular, the EC's standards of prudence for valuing assets and liabilities with regard to the calculation of technical reserves remain relatively general. Consequently, insurance companies of different member states may assess the values of the same types of assets and liabilities according to different interpretations of the EC's standards.

Supervisory Reporting

As previously discussed, the accounts directive attempts to ensure that public financial information about an EC insurance company based in any member state is available in a standard format. However, the directive only applies to the financial statements of insurance companies that are intended for the general public. Specifically, the directive does not harmonize requirements for financial statements that insurance companies must submit to the supervisory authorities from their respective home states. Requirements for such supervisory reports, which are intended to demonstrate an insurance company's prudential soundness, differ from those for publicly disclosed statements and vary among the member states. For example, the supervisory reports submitted by a U.K. insurance company to the U.K.'s Department of Trade and Industry must be audited and made available to the general public. In contrast, the supervisory reports submitted by an Italian insurance company to the Italian Institute for Control of Private Insurance Companies are largely unaudited and not accessible to the general public. Furthermore, these officials recognize that the figures presented in supervisory returns from different member states would still reflect the member states' different accounting principles and would therefore not be fully comparable.

Such differences in supervisory reporting requirements may affect the decisions of insurance companies to base their operations in specific member states. For example, officials of one insurance company we interviewed indicated that the company decided to establish its head office in a particular member state in part because the state's supervisory reporting requirements were less onerous than those of other member states in which the company conducted business.

Antifraud Measures

The EC framework of insurance regulation contains no specific EC-wide provisions to address fraud. According to EC officials, the EC does not intend to harmonize the member states' existing systems for supervising fraud because such systems are already adequate and because EC-level mechanisms have not been suggested or discussed. In the U.K., for example, the U.K.'s Department of Trade and Industry requires that an insurance company's directors, controllers, and managers be "fit and proper" for their positions before authorizing the company to conduct business. Furthermore, the U.K. established a Serious Fraud Office to investigate and prosecute significant cases of fraud in any industry.

According to some market analysts, however, some member states may be better prepared to address fraud than others. They also believe that the envisioned single insurance market could present unscrupulous individuals and companies with new possibilities to perpetrate fraud on an EC-wide scale.

Although the EC has not adopted specific measures to address fraud that would supplant existing member state mechanisms, it has adopted provisions that will require all member states to assess the qualifications and reputations of an insurance company's managers and major shareholders before authorizing the company to conduct business. According to the EC, these provisions, which are similar to the U.K.'s "fit and proper" requirements mentioned previously, are necessary to safeguard the general quality of business of an insurance company as well as the day-to-day management of the company.

Uncertainties About Other Issues

Uncertainties remain about how some aspects of the EC system of insurance regulation that have been adopted by the EC will work when fully implemented by the member states. Member states are still modifying their existing regulatory systems to conform to two major insurance directives adopted by the EC in 1992. These directives introduce crucial elements of the EC's regulatory system, including the full provision of cross-border services, the single licensing of insurance companies, the financial supervision of insurance companies solely by home states, and the further harmonization of technical reserve requirements. Although the

EC adopted these directives in 1992 to finally achieve the single European insurance market, member states have until 1994 to bring the provisions of these directives into force.

Some member state officials and industry analysts expressed uncertainty about how member state supervisors will adapt to a supervisory framework based on minimum prudential standards. Traditionally, some member states, including France, Germany, and Italy, have required insurance companies to submit proposed premium rates and policy conditions to their respective insurance supervisors for approval before issuing some policies in certain insurance lines, particularly life and compulsory motor vehicle liability insurance. According to officials of these member states, such requirements, called material controls, protect consumers by ensuring that insurance companies charge appropriate premiums to pay for claims and remain solvent.[10] In contrast, insurance supervisors of other member states, such as the U.K., have generally not used material controls. According to the U.K.'s Insurance Supervisor, for example, such requirements tend to limit choices for consumers, increase the cost of insurance, and restrict the competitive strategies of insurance companies without necessarily ensuring the financial soundness of insurance companies.

Similarly, the EC considers requirements for the prior approval of premiums and policy conditions to be unnecessary in a single EC-wide insurance market. According to the EC, the harmonization of prudential standards and the general application of the contract law of the policyholder's member state strike an appropriate balance between providing consumers with freedom of choice and adequate protection. EC officials stated that all member states, despite their historically different approaches to insurance regulation, are now committed to ensuring the success of the EC framework of insurance regulation, including those that have traditionally used material controls.

Uncertainties also exist about the level of cooperation among member state supervisors that will be required by the EC framework of insurance regulation. Traditionally, member state supervisors have monitored both the financial condition and the business operations of all insurance companies in their national markets. Under the EC framework, however, home states will be responsible for ensuring the financial soundness of their insurance companies' operations throughout the EC, while host states

[10]Although the EC will prohibit material controls, member state supervisors will still be able to request that insurance companies provide nonsystematic notification of premium rates and policy conditions after policies have been issued.

will supervise the conduct of business of all insurance companies in their national markets. Furthermore, an insurance company's operating license from its home state will become valid in all member states. Because member states will rely on the financial supervision of insurance companies by other member states to protect their consumers, the EC framework will require a high degree of cooperation and trust among member state supervisors, EC and member state officials agreed.

According to EC and member state officials, cooperation and trust have already developed informally among the insurance regulators and supervisors of the member states over the years. For example, these officials pointed out that negotiations over EC insurance directives have themselves increased the level of trust and confidence among the member state authorities. The insurance supervisors of the member states have also been meeting periodically since 1957 through the Conference of the Insurance Supervisory Services of EC Countries. The Conference was established as a forum for these authorities to study and exchange information on issues involving insurance regulation.[11] In addition, EC and member state officials agree that peer pressure, both to ensure the success of the EC program and to avoid blame for the program's failure, also fosters cooperation among the member states.

In addition, through various provisions in its insurance directives, the EC has formally recognized the need for member state authorities to cooperate. For example, the EC requires the EC Commission and member state authorities to "collaborate closely" in supervising insurance companies within the EC. Recently adopted directives also allow, but do not require, member state authorities to exchange confidential information and to conclude bilateral agreements for such information exchanges. In addition, the EC is establishing an "early warning system" among member state authorities to supervise life insurance companies. Under the system, a host state supervisor of a life insurance company must inform the company's home state supervisor of any suspicions regarding the company's financial soundness. Furthermore, the system obliges the home state supervisor to investigate such cases.

The EC has also recently created an Insurance Advisory Committee to advise the EC Commission on the implementation of existing insurance directives and the development of proposed insurance legislation. According to EC officials, the Committee, composed of the insurance

[11]According to at least one market analyst, past meetings of the Conference fostered personal contacts among member state supervisory officials, but did not result in formal, substantive coordination of regulatory practices among member state supervisors.

supervisors of the member states and representatives of the EC Commission, also provides a forum for information exchanges and discussions about regulatory issues among the member state supervisors.[12] In addition, in the view of EC officials, the Conference of the Insurance Supervisory Services of EC Countries has recently been more proactive in providing guidance and recommendations to member state insurance supervisors. In particular, the Conference, while not an official EC organization, has developed formal protocols for member state supervisors to coordinate their implementation of specific EC insurance directives.

EC and member state officials are generally optimistic about the willingness of member state supervisors to cooperate. However, at least two insurance supervisors we interviewed indicated that they would not guarantee to their consumers the soundness of policies issued by insurance companies based in other member states, since they would not be responsible for the financial supervision of such companies.

Some industry analysts are also uncertain about the ability of all member state authorities to supervise their insurance companies' financial condition throughout the EC. According to some industry analysts, some member state authorities may need additional money or expertise to assume their responsibilities as home state supervisors. Member states accustomed to material controls over insurance companies may also need to reorient their supervisory practices once such controls are eliminated, as required by the EC. In addition, EC and member state officials recognize the need to become more knowledgeable about each other's regulatory and supervisory systems, particularly if insurance companies increase their cross-border operations in the single market.

To address these concerns, the EC requires member states to ensure that their insurance supervisors have the "necessary powers and means" to fulfill their responsibilities. However, the EC does not specify how member states should fulfill this requirement. The EC has also given home state supervisors the right to conduct on-site inspections of their insurance companies' branch operations in other member states, although some industry observers believe that such inspections could raise concerns about member state sovereignty. In addition, some member state supervisors suggested that interstate staff exchanges, training, and other

[12] The EC has established equivalent advisory committees in the banking and investment services sectors.

cooperative efforts may be necessary in the future to improve the level of technical expertise among some member state supervisors.

Uncertainties also exist about how member states will interpret certain EC criteria for taking supervisory actions against insurance companies. Specifically, to protect consumers, the EC allows a host state to prevent an insurance company supervised by another member state from issuing an insurance policy that conflicts with the host state's "legal provisions protecting the general good." However, the EC has not defined the "general good." According to EC officials, although each member state may define the "general good" by its own national standards, all such interpretations will be subject to the jurisdiction of the European Court of Justice.[13] Furthermore, EC officials contend that similar legal concepts of the "general good" (i.e., the public interest or consumers' interest) already exist among the member states.

In previous judgments, the Court ruled that, in the absence of further harmonization, member states may only impose restrictions to protect the "general good" under certain circumstances. Specifically, the Court ruled that such restrictions against an insurance company must be objectively necessary; must not discriminate; must represent the least restrictive way of achieving the objective; and must not duplicate relevant regulatory safeguards in the insurance company's home state. However, some industry analysts are concerned that some member states might improperly use the "general good" to discriminate against insurance companies based in other member states, rather than to protect consumers.

Currently, laws for defining insurance companies as insolvent and disposing of their assets also vary among the member states. The EC has specified both voluntary and mandatory actions for supervisors to take against an insurance company that fails to meet minimum prudential requirements.[14] In contrast, the EC provides relatively general criteria for supervisory action in the proposed directive on the dissolution of

[13]See appendix II for a description of the European Court of Justice.

[14]Under the EC framework of insurance regulation, if an insurance company has not established sufficient technical reserves, its home state supervisor may prohibit the company from freely disposing of its assets. However, if an insurance company's solvency margin falls below the minimum level, its home state supervisor is required to request that the company submit a plan for restoring its financial health. Furthermore, if an insurance company's solvency margin falls below the required guarantee fund, the home state supervisor must require the insurer to submit a short-term financing scheme and may call upon other member state supervisors for assistance.

insolvent insurance companies.[15] However, the proposal, which was introduced in 1989 but has not yet been adopted, still does not establish a precise definition of insolvency. Instead, the proposal requires member state supervisors to dissolve an insurance undertaking "where it appears probable that the assets of the undertaking are no longer sufficient to cover existing liabilities, or where the undertaking is found to be insolvent or to have ceased to pay its debts."

According to EC officials, the EC is monitoring the Council of Europe's current efforts to create an international convention on bankruptcy applicable to all types of businesses. However, this convention has not yet been ratified, and some industry analysts doubt that the measure will be adopted in the near future.

Finally, uncertainties remain about the effects of increased competition in the single insurance market on the financial soundness of insurance companies. Although EC and member state officials contended that the minimum prudential standards are sufficient to ensure that insurance companies will be able to pay claims and remain solvent, they recognized that the transition to the single insurance market and regulatory framework will require increased supervisory vigilance.

According to EC and member state officials, insurance company insolvencies have so far rarely occurred in the EC. In part, some analysts attribute this favorable record to regulatory controls in some member states that have protected markets from outside competition and set premiums at relatively high levels. However, some industry analysts believe that, as occurred in the EC banking industry in the 1980s, the competitive pressures of an EC-wide insurance market may lead insurance companies to pursue expansionist strategies by acquiring or establishing operations in several member states. According to some analysts, such strategies could cause a consolidation of companies within the industry and a reduction in the financial capital of the remaining large insurance companies. Nevertheless, a final assessment of the EC framework of insurance regulation must await the implementation of the framework by the member states, as well as the competitive strategies eventually pursued by insurance companies in the single insurance market.

[15]This measure is entitled the "amended proposal for a council directive on the co-ordination of laws, regulations and administrative provisions relating to the compulsory winding-up of direct insurance undertakings."

The EC: An Overview

The Single Market Program

The Treaty of Rome, which established the EC in 1957, heralded the beginning of the EC's drive toward economic integration. Through the treaty, the EC set out to establish a common market and coordinate the economic policies of its member states. Although the treaty called for the free movement of goods, persons, services, and capital within the EC, it did not create a framework to achieve this goal. Initially, the treaty focused on the elimination of tariff barriers and the promotion of tax harmonization. The subsequent creation of the European Monetary System (EMS) in 1979 established ECU for accounting purposes based on the values of the member states' individual currencies. It also helped to stabilize exchange rates within the EC and paved the way toward future cooperation.

Despite these initial steps toward integration, many internal obstacles remained. Continuing trade barriers and protected markets among the member states exacerbated Europe's slow recovery from the global economic recession of the 1970s. The EC's dependence on world trade and the increasing internationalization of the world's economies provided additional impetus to revive the EC's plan to unify its member states' markets.

Consequently, the EC formally launched its single market program in 1985 with the publication of a White Paper entitled "Completing the Internal Market." This paper identified technical, fiscal, and physical barriers to free trade among the member states, proposed a series of 300 measures (later reduced to 279) to abolish these barriers, and established a regulatory framework for achieving a single European market.

Under the White Paper's framework, most measures for eliminating the remaining barriers take the form of "directives." EC directives require member states to ensure that their national laws and regulations conform to the directives' provisions within specified time frames. Nevertheless, the directives allow the member states considerable discretion in how they implement the provisions. The White Paper also established a goal for the EC to adopt the measures for the single market program by the end of 1992.

In 1987, the EC adopted the Single European Act to provide the necessary legislative means to achieve the White Paper's objectives and accelerate the integration of member state markets. Specifically, the act changed the legislative process for most initiatives involving the single market program: It required only a weighted majority of member states for the approval of proposed directives. Previously, although qualified majority voting already existed, unanimity among the member states was required in a greater number of areas affecting the single market. This system allowed any one member state to block proposed legislation. In addition, as discussed in the following section, the act provided for greater consultation among the various EC institutions during the legislative process.

For the financial services sectors—banking, securities, and insurance—the single market program emphasizes the unrestricted movement of capital within the EC; the ability of financial firms to operate throughout the EC under essentially similar regulations; and the use of reciprocity to open other countries' markets to EC firms. In addition, the EC aims to establish sufficient regulatory mechanisms to ensure the safety and soundness of financial firms. At the same time, the mechanisms are intended to give financial firms adequate flexibility without imposing overly burdensome regulation.[1]

Institutions

The EC consists of four governing supranational institutions: the EC Commission, the Council of Ministers, the European Parliament, and the European Court of Justice. As the executive body of the EC, the Commission drafts and proposes EC legislation and enforces the implementation of EC law. The Commission consists of commissioners from each of the various member states (two each from France, Germany, Italy, Spain, and the U.K., and one each from the other member states).

The Council of Ministers, on the other hand, represents the views of the individual member states and is the EC's principal decision-making body. The Council consists of ad hoc groupings of cabinet-level officials from the member states. For example, for the financial services sectors, the Council consists of the finance ministers of all member states. The Council must approve legislation proposed by the Commission before it becomes law.

The European Parliament, whose members are elected directly by citizens of the various members states, acts as the EC's public forum, debating issues of public importance and questioning the Commission and the Council. Although the Parliament cannot initiate or enact legislation on its own, it can make amendments to proposed directives in accordance with the "cooperation procedure" described on page 30. As a result, the Commission and the Council are sensitive to the Parliament's concerns.

[1]For further information on the EC's single market program for the financial services, see European Community: U.S. Financial Services' Competitiveness Under the Single Market Program (GAO/NSIAD-90-99, May 21, 1990).

Finally, the European Court of Justice ensures that the member states and individual parties interpret and apply the provisions of the single market program according to EC legislation. As the single market program progresses, the Court is expected to play an increasingly important role in interpreting and enforcing the single market program.

Legislative Process for Insurance Legislation

Under the Single European Act, the enactment of legislation for the single market program must follow the cooperation procedure, a consultative process involving the Commission, the Council of Ministers, and the European Parliament.

The Insurance Division of the Commission's Directorate General for Financial Institutions and Company Law drafts and proposes EC legislation regarding insurance matters. After approval by the Commission, such legislative proposals are submitted to the Council and the Parliament for review. As the Council begins its deliberations, the Parliament conducts a "first reading" of the proposal and renders a formal opinion.[2] This opinion is not binding on the Council, which then adopts a "common position" reflecting political agreement on the proposal through qualified majority voting.

Within 3 months, the Parliament reviews the Council's common position in a "second reading" of the proposal. If the Parliament approves of or makes no comment on the Council's common position, the Council may adopt the proposal in accordance with the common position through qualified majority voting. If the Parliament rejects the Council's common position, however, the Council may only adopt the proposal by unanimous vote within 3 months.

Alternatively, the Parliament may amend the proposal during its second reading. Within 1 month, the Commission must then decide either to accept or reject the Parliament's amendments. If the Commission accepts the Parliament's amendments, the Council may subsequently adopt the proposal by qualified majority voting within 3 months. If the Commission rejects the Parliament's amendments, however, the Council may only adopt the proposal by unanimous vote within 3 months.

[2]For insurance legislation, the Parliament's first opinion is mostly based on that of its Legal Affairs and Citizens' Rights Committee, which in turn consults with the Parliament's Economic and Monetary Affairs Committee and European Economic and Social Committee.

EC Insurance Markets

The insurance markets of the 12 EC member states accounted for almost 27 percent, or about $363 billion, of all insurance premiums collected worldwide in 1990, making the EC the world's second largest insurance market after the United States (see table III.1). Between 1984 and 1989, the combined EC insurance market grew by about 74 percent in terms of gross premiums. An important part of the overall EC economy, the insurance industry accounted for 5.6 percent of the EC's gross domestic product in 1990 and employed over 1.25 million individuals in 1989.

Of the total EC insurance market, the nonlife insurance sector accounted for about 52 percent, while the life insurance sector represented about 48 percent in 1990.[1] More than four-fifths of all EC insurance premiums in 1990 came from the U.K., Germany, France, and Italy, which have the third, fourth, fifth, and eighth largest national insurance markets in the world, respectively (see tables III.2, III.3, and III.4).

In 1989, 4,462 direct insurance companies operated in the EC. Of these companies, 3,348 were nonlife companies, 1,044 were life companies, and 270 were composite companies. Despite the relatively high number of companies, however, member state insurance markets are dominated by a relatively small number of companies. For example, the 10 largest nonlife insurance companies of the U.K., Italy, France, and Germany accounted for 72.5, 48, 47.6, and 36.7 percent of their respective national markets in 1987. Industry analysts expect such market concentration to increase as a result of the EC single market program.

On average, EC consumers spend less on insurance than those in the United States. In 1990, insurance premiums per capita in the EC averaged $1,105, compared with $1,929 in the United States. However, among the individual EC member states, premiums per capita ranged from $104 in Greece to $1,775 in the U.K. Per capita insurance expenditures in the northern EC member states are generally higher than those in the four southern EC member states of Greece, Italy, Portugal, and Spain. However, according to industry analysts, the southern EC insurance markets are expected to grow more rapidly in the single insurance market.

Methods of insurance distribution also differ among the member states. For example, while U.K. and Dutch consumers have traditionally used

[1]The EC refers to nonlife insurance as insurance against accidents; sickness; marine, aviation, and transport risks; fire and other property damage; credit and suretyship; and miscellaneous liability risks. In contrast, the EC defines life insurance to include various long-term lines of insurance, including life insurance; annuities; supplementary personal injury (accidental death or disability) insurance; and management of pension funds.

independent insurance intermediaries to obtain insurance policies, other EC consumers have tended to rely on agents tied to specific insurance companies. According to industry analysts, some EC insurance companies that are expanding their cross-border operations are acquiring existing companies in other member states partly for their established distribution networks.

Table III.1: Comparison of World Insurance Markets by Premium Income (Total, Nonlife, and Life Business)

U.S. dollars

		1990 premium income		
Type of insurance	**Country**	**Per capita**	**Total (in millions)**	**Percent of world market**
Total business	EC	$1,104.94	$362,529	26.74
	EFTA	1,676.69	54,383	4.01
	Japan	2,252.49	278,273	20.53
	U.S.	1,928.66	482,108	35.56
	Rest of world	NA	178,435	13.16
	Total world	**NA**	**1,355,728**	**100.00**
Nonlife business	EC	574.86	188,609	29.09
	EFTA	814.74	26,426	4.08
	Japan	607.04	74,994	11.56
	U.S.	1,105.54	276,352	42.62
	Rest of world	NA	82,075	12.66
	Total world	**NA**	**648,456**	**100.00**
Life business	EC	530.08	173,919	24.59
	EFTA	861.95	27,957	3.95
	Japan	1,645.45	203,279	28.74
	U.S.	823.12	205,756	29.09
	Rest of world	NA	96,362	13.62
	Total world	**NA**	**707,273**	**100.00**

Legend:

EFTA = European Free Trade Area
NA = Not Available

Source: sigma, Swiss Reinsurance Company.

Table III.2: Insurance Markets of EC Member States by Premium Income (Total Business)

U.S. dollars

	1990 premium income				
Member state	Per capita	Total (in millions)	Percent of EC market	Rank in EC	Rank in world
Belguim	$868.24	$8,674	2.39	7	17
Denmark	1,219.02	6,266	1.73	8	20
France	1,316.74	74,317	20.50	3	5
Germany	1,462.79	92,451	25.50	2	4
Greece	103.94	1,045	0.29	11	35
Ireland	1,232.15	4,313	1.19	9	23
Italy	524.16	30,223	8.34	4	8
Luxembourg	1,167.48	449	0.12	12	49
Netherlands	1,613.20	24,101	6.65	5	10
Portugal	206.32	2,173	0.60	10	29
Spain	431.25	16,801	4.63	6	13
United Kingdom	1,775.15	101,716	28.06	1	3
Total EC	**$1,104.94**	**$362,529**	**100.00**		

Source: sigma, Swiss Reinsurance Company.

Table III.3: Insurance Markets of EC Member States by Premium Income (Nonlife Business)

U.S. dollars

	1990 Premium income				
Member state	Per capita	Total (in millions)	Percent of EC market	Rank in EC	Rank in world
Belgium	$616.87	$6,163	3.27	7	13
Denmark	713.10	3,665	1.94	8	17
France	624.30	35,236	18.68	3	5
Germany	899.76	56,867	30.15	1	3
Greece	60.47	608	0.32	11	38
Ireland	499.22	1,747	0.93	9	26
Italy	391.23	22,558	11.96	4	6
Luxembourg	777.26	299	0.16	12	50
Netherlands	778.26	11,627	6.16	6	10
Portugal	157.13	1,655	0.88	10	28
Spain	310.93	12,114	6.42	5	9
United Kingdom	629.51	36,071	19.13	2	4
Total EC	**$574.86**	**$188,610**	**100.00**		

Source: sigma, Swiss Reinsurance Company.

Table III.4: Insurance Markets of EC Member States by Premium Income (Life Business)

U.S. dollars

	1990 Premium income				
Member state	**Per capita**	**Total (in millions)**	**Percent of EC market**	**Rank in EC**	**Rank in world**
Belguim	$251.40	$2,512	1.44	9	22
Denmark	505.92	2,600	1.49	7	19
France	692.44	39,081	22.47	2	4
Germany	563.03	35,585	20.46	3	5
Greece	43.47	437	0.25	11	34
Ireland	732.93	2,565	1.47	8	21
Italy	132.93	7,665	4.41	5	13
Luxembourg	390.22	150	0.09	12	42
Netherlands	834.94	12,474	7.17	4	9
Portugal	49.19	518	0.30	10	31
Spain	120.32	4,688	2.70	6	17
United Kingdom	1,145.63	65,645	37.75	1	3
Total EC	**$530.08**	**$173,919**	**100.00**		

Source: sigma, Swiss Reinsurance Company.

EC Minimum Prudential Standards for Insurance Regulation

Under the EC framework of insurance regulation, home state supervisors must ensure that their insurance companies meet three minimum prudential standards: technical reserves, solvency margins, and guarantee funds. In this appendix, each of these standards is discussed and explained. Appendix V lists the technical specifics used by regulators to implement the prudential standards. These requirements are intended to ensure that insurance companies are financially sound with regard to their EC-wide operations.

Technical Reserves

Insurance companies in the EC must maintain sufficient assets as technical reserves to cover all underwriting liabilities. The EC prescribes guiding principles rather than detailed rules for member state supervisors to calculate technical reserve requirements. EC technical reserves correspond roughly to the unearned premium reserves and unpaid loss reserves that U.S. insurance companies must maintain to ensure their ability to meet underwriting obligations to policyholders. Currently, each member state in which an insurance company provides services imposes a separate technical reserve requirement to cover the company's underwriting liabilities in each state. However, beginning in 1994, each insurance company will be subject to only one overall technical reserve requirement. This requirement will cover its underwriting liabilities throughout the EC, and will be imposed by its home state supervisor.

The EC requires that assets covering technical reserves reflect the type of business carried on by an insurance company in such a way as to secure the safety, yield, and marketability of the company's investments. The EC also requires that assets be diversified and adequately spread. Consequently, the EC specifies the types of assets that insurance companies may use as technical reserves. However, member states may apply more detailed rules regarding the permissible uses of these assets. For example, a member state may require valuable security or guarantees, particularly in the case of debts owed by reinsurance companies.[1] Such rules must also comply with general valuation principles established by the EC. Nevertheless, under exceptional circumstances and at an insurance company's request, a member state may temporarily accept other categories of assets to cover technical reserves.

The EC also limits how much insurance companies may invest in certain assets used to cover technical reserves. Member states may impose further

[1]Reinsurance is insurance for insurers. That is, an insurer can reduce its exposure to a risk or a group of risks by reinsuring them with another company. Then, when a claim is made on a policy originally sold by the insurer, it will be reimbursed by the reinsurer for the portion of the risk that was passed.

limits on insurance company investments in other types of permissible assets, provided that such limits conform to certain principles. The EC also requires those member states that permit insurance companies to use claims against reinsurance companies to cover technical reserves to specify the percentage of the reserves that companies can cover with such claims. In addition, member states must limit how insurance companies use the following assets as technical reserves: unsecured loans; investment funds that are not incorporated under EC provisions; securities that are not traded in a regulated market; and certain bonds, debt securities, and other money and capital market instruments not issued by member state, local, or regional authorities. Under exceptional circumstances and at an insurance company's request, however, member states may temporarily allow exceptions to such investment limitations.

Although the EC allows member states to prohibit or limit insurance company investments in assets used as technical reserves, it prohibits member states from imposing certain additional requirements. For example, member states may not require insurance companies to invest in any particular assets. In addition, member states may not require insurance companies to locate assets used as technical reserves in any specific member state.

Solvency Margins

Solvency margins are assets in addition to technical reserves that an insurance company must maintain to provide against business fluctuations. EC solvency margins correspond roughly to the policyholders' surpluses (defined as total assets less total liabilities) maintained by U.S. insurance companies as additional financial protection for policyholders in the event of unexpected or catastrophic losses.

Solvency margins consist of an insurance company's assets that are free of all foreseeable liabilities, less any intangible items. The level of solvency margin that an EC insurance company must maintain depends on its volume of business conducted in the previous year throughout the EC, based either on premiums or claims.

Guarantee Funds

Guarantee funds are assets that ensure that (1) an insurance company has adequate resources when it is established and (2) its solvency margin never falls below a minimum level of security. EC guarantee funds do not correspond to the guarantee funds maintained by some U.S. states to protect claims against insolvent insurance companies. Instead, they correspond more closely to minimum capital and surplus standards imposed on U.S. insurance companies by U.S. state insurance regulators.

The guarantee fund is part of the solvency margin and represents a minimum capitalization requirement that insurance companies must possess before obtaining authorization to conduct business. An insurance company must maintain a minimum guarantee fund corresponding to the higher of either one-third of its required solvency margin or a specified absolute level.

Defining and Calculating the Elements of the Minimum Prudential Standards for Insurance Regulation

As described in appendix IV, the minimum prudential standards that underpin the EC's framework of insurance regulation consist of requirements for size and composition of three solvency elements to be maintained by insurance companies in all EC countries. These elements are technical reserves, solvency margins, and guarantee funds. Here we list the technical details provided by the EC to the member states. These directions are intended to help insurance regulators ensure that their domestic insurers meet the standards.

I. Technical reserves

A. Calculation of technical reserves

1. Nonlife insurance companies (technical reserves must meet liabilities for each of the following):

a. Unearned premiums, defined as that portion of gross written premiums that an insurer has already collected for its policies, but will not claim as income until subsequent financial years covered by those policies;

b. Outstanding claims consisting of the total estimated ultimate cost to an insurance company of settling all claims arising from events that have occurred up to the end of the financial year, whether reported or not, less amounts already paid in respect of such claim;

c. Bonuses and rebates intended for policyholders or contract beneficiaries;

d. Equalization provisions representing amounts set aside in compliance with legal or administrative requirements to equalize fluctuations in loss ratios in future years or to provide for special risks; and

e. Other provisions, including unexpired risks, that are amounts set aside in addition to unearned premiums in respect of risks to be borne by the insurance company after the end of the financial year to provide for all claims and expenses in connection with insurance contracts in force in excess of the related unearned premiums and any premiums receivable on those contracts.

2. Life insurance companies

a. Technical reserves should be calculated by sufficiently prudent actuarial valuation of all future liabilities of existing policies, including guaranteed bonuses and surrender values, policyholder options, and future bonuses, expenses, and commissions.

b. Retrospective methods of valuation must be consistent with prudent prospective calculations.

c. Prudent valuation must consider an appropriate margin for adverse deviation and the method of valuing corresponding assets.

d. No fixed rate of interest is required to be applied in calculating technical reserves, but the rate must be prudent, taking into account the currency of the policy and the yield of existing investments.

e. The methods used from year to year must recognize profit in an appropriate way over the life of the policy.

B. Permissible assets for technical reserves

1. Investments (debt securities, bonds, and other money and capital market instruments; loans; shares and other variable-yield participation; units in undertakings for collective investment in transferable securities and other investment funds; land, buildings, and immovable property rights);

2. Debts and claims (debts owed by reinsurance companies, including reinsurers' shares of technical provisions; deposits with and debts owed by ceding undertakings; debts owed by policyholders and intermediaries arising out of direct and reinsurance operations; tax recoveries; claims against guarantee funds; for nonlife insurance companies, claims arising out of salvage and subrogation; for life insurance companies, advances against policies);

3. Other assets (tangible fixed assets other than land and buildings, valued on the basis of prudent amortization; cash at bank and in hand, deposits with credit institutions, and any other bodies authorized to receive deposits; deferred acquisition costs; accrued interest and rent, other accrued income and prepayments; for life insurance companies, reversionary interests);

4. The Lloyd's association of underwriters may also use guarantees and letters of credit issued by credit institutions and insurance companies regarding funds belonging to members.

C. Valuation principles for technical reserves

1. Assets covering technical reserves must be valued net of any debts arising out of their acquisition.

2. All assets must be valued on a prudent basis, allowing for the risk of any amounts not being realizable.

3. Loans may be accepted only if there are sufficient guarantees as to their security, based on the status of the borrower, mortgages, bank guarantees, guarantees granted by insurance companies, or other forms of securities.

4. Derivative instruments, such as options, futures, and swaps, may be used only if they contribute to reducing investment risks or facilitate efficient portfolio management and are valued on a prudent basis, taking into account the valuation of the underlying assets.

5. Transferable securities that are not traded on a regulated market must be realizable in the short term.

6. Debts owed by and claims against a third party must be deducted by all amounts owed to the same third party.

7. The value of any debts and claims must be calculated on a prudent basis, allowing for the risk of any amounts not being realizable. Debts owed by policyholders and intermediaries arising out of insurance and reinsurance operations may be accepted only if they have been outstanding for not more than 3 months.

8. Where the assets represent an investment in a subsidiary company that manages all or part of the insurance company's investments on its behalf, the home member state must consider the underlying assets held by the subsidiary company.

9. Deferred acquisition costs must be consistent with calculations for unearned premiums.

D. Investment limits for technical reserves (an insurance company may invest no more than the following percentages of its technical reserves in specific permissible assets):

1. Ten percent in any one piece of land or building, or a number of pieces of land or buildings close enough to each other to be effectively considered as one investment;

2. Five percent in shares and other negotiable securities, treated as shares, bonds, debt securities, and other money and capital market instruments from the same company, or in loans granted to the same borrower, taken together, the loans being loans other than those granted to a member state, regional, or local authority, or to an international organization of which one or more member states are members (this limit may be raised to 10 percent if an insurance company does not invest more than 40 percent of its technical reserves in the loans or securities of issuing bodies and borrowers in each of which it invests more than 5 percent of its assets);

3. Five percent, including 1 percent for any single unsecured loan, other than loans granted to credit institutions, insurance companies, and EC investment companies;

4. Three percent in the form of cash in hand; and

5. Ten percent in shares, other securities treated as shares, and debt securities that are not traded in a regulated market.

E. Guidelines for member state limits on technical reserves

1. Assets must be diversified and spread to ensure that there is no excessive reliance on any particular type of asset, investment market, or investment.

2. Investments in assets that show high levels of risk, whether because of the nature of the asset or the quality of the issuer, must be restricted to prudent levels.

3. Limitations on particular asset categories must consider the treatment of reinsurance in the calculation of the technical reserves.

4. Where the assets include an investment in a subsidiary company that manages all or part of the insurance company's investments on its behalf,

the home member state must consider the underlying assets held by the subsidiary company.

5. The percentage of assets that are the subject of nonliquid investments must be kept to a prudent level.

6. Where assets include loans to or debt securities issued by certain state-owned credit institutions, the home member state must consider the underlying assets held by such institutions.

II. Solvency margins

A. Calculation of solvency margins[1]

1. Nonlife insurance company (the minimum solvency margin that a nonlife insurance company must maintain is the higher of the following two calculations):

a. Eighteen percent of total gross premiums up to ECU 10 million ($12 million), plus 16 percent of those premiums above ECU 10 million;

b. Twenty-six percent of claims incurred up to ECU 7 million ($8.4 million), plus 23 percent of those claims above ECU 7 million.

2. Life insurance company (the minimum solvency margin is the sum of the following two calculations):

a. Four percent of mathematical reserves (a portion of the technical reserves) multiplied by a certain ratio not less than 85 percent;

b. For policies on which the capital at risk is not a negative figure, 0.3 percent of the capital underwritten multiplied by another ratio not less than 50 percent.

B. Components of the solvency margin (the following assets compose the solvency margin of an insurance company):

1. The company's paid-up share capital (or, for mutual insurance companies, the effective initial fund plus certain members' accounts);

[1]The minimum solvency margin is defined in terms of ECUs.

2. One-half of the company's unpaid share capital or initial fund, once the paid-up part amounts to 25 percent of that share capital or fund;

3. Reserves that do not correspond to underwriting liabilities;

4. Any profits brought forward;

5. For nonlife mutual insurance companies with variable contributions, any claims against members by way of calls for supplementary contributions (up to one-half of the difference between the maximum contributions and the contributions actually called in), subject to a limit of 50 percent of the margin;

6. At the request of and production of proof by a nonlife insurance company, any hidden reserves arising out of the undervaluation of assets if such hidden reserves are not of an exceptional nature;

7. Cumulative preferential share capital and subordinated loan capital, subject to a limit of 50 percent of the margin, no more than 25 percent of which may consist of certain subordinated loans with a fixed maturity or fixed-term cumulative preferential share capital; and

8. Fully paid-up amounts of certain securities without specified maturity dates and other instruments.

III. Guarantee funds[2] (absolute minimum levels)

A. Nonlife insurance company—ECU 200,000 ($240,000) to ECU 400,000 ($480,000), depending on the types of risks underwritten.

B. Life insurance company—ECU 800,000 ($960,000); ECU 100,000 ($120,000) to ECU 600,000 ($720,000) for mutual companies.

[2]The minimum guarantee fund is also defined in terms of ECUs (see footnote 3 in app. I on p. 10).

Summary of EC Insurance Directives Adopted and Proposed as of December 31, 1992

Directive and date of adoption	Title	Status of implementation
Reinsurance February 25, 1964	Council Directive on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance retrocession	In force
Motor Insurance April 24, 1972	Council Directive on the approximation of the laws of the member states relating to insurance against civil liability in respect of the use of motor vehicles and to the enforcement of the obligation to insure against such liability	In force
Direct Nonlife Insurance July 24, 1973	First Council Directive on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of direct insurance other than life assurance	In force
Direct Nonlife Insurance July 24, 1973	Council Directive on abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance	In force
Unit of Account June 29, 1976	Council Directive amending the First Council Directive of July 24, 1973, on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance	In force
Intermediaries December 13, 1976	Council Directive on measures to facilitate the effective exercise of freedom of establishment and freedom to provide services in respect of activities of insurance agents and brokers and, in particular, transitional measures in respect of those activities	In force
Coinsurance May 30, 1978	Council Directive on the coordination of laws, regulations, and administrative provisions relating to EC coinsurance	In force
Direct Life Assurance March 5, 1979	First Council Directive on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct life assurance	In force
Motor Insurance December 30, 1983	Second Council Directive on the approximation of the laws of member states relating to insurance against civil liability in respect of the use of motor vehicles	In force in nine member states; to be fully implemented by Greece, Portugal, and Spain by January 1996
Tourist Assistance December 10, 1984	Council Directive amending, particulary as regards tourist assistance, the First Council Directive of July 24, 1973, on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance	In force
Credit and Suretyship June 22, 1987	Council Directive amending, as regards credit insurance and suretyship insurance, the First Council Directive of July 24, 1973, on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance	In force
Legal Expenses June 22, 1987	Council Directive on the coordination of laws, regulations, and administrative provisions relating to legal expenses insurance	In force
Direct Nonlife Insurance June 22, 1988	Second Council Directive on the coordination of laws, regulations, and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending the First Council Directive of July 24, 1973	In force

(continued)

Directive and date of adoption	Title	Status of implementation
Motor Insurance May 14, 1990	Third Council Directive on the approximation of the laws of the member states relating to insurance against civil liability in respect of the use of motor vehicles	To be fully implemented by eight member states by January 1993; Greece, Portugal, and Spain by January 1996; and Ireland by January 1999
Motor Insurance November 8, 1990	Council Directive amending, particulary as regards motor vehicle liability insurance, the First Council Directive of July 24, 1973, and the Second Council Directive of June 22, 1988, which concern the coordination of laws, regulations, and administrative provisions relating to direct insurance other than life assurance	To be fully implemented by all member states by November 1992
Direct Life Assurance November 8, 1990	Second Council Directive on the coordination of laws, regulations, and administrative provisions relating to direct life assurance, laying down provisions to facilitate the effective exercise of freedom to provide services and amending the First Council Directive of March 5, 1979	To be fully implemented by nine member states by May 1993; Spain by January 1996; and Greece and Portugal by January 1999
Swiss Bilateral June 20, 1991	Council Directive on the implementation of the agreement between the EEC and the Swiss Confederation concerning direct insurance other than life assurance	To be fully implemented by member states by June 1993
Annual Accounts and Consolidated Accounts December 19, 1991	Council Directive on the annual accounts and consolidated accounts of insurance undertakings	To be fully implemented by all member states by 1994
Regulatory Committee on Insurance December 19, 1991	Council Directive setting up an insurance committee	In force
Direct Nonlife Insurance June 18, 1992	Third Council Directive on the coordination of laws, regulations, and administrative provisions relating to direct insurance other than life assurance and amending the First Council Directive of July 24, 1974, and the Second Council Directive of June 22, 1988	To be fully implemented by nine member states by July 1994; Spain by January 1997; and Greece and Portugal by January 1999
Direct Life Assurance November 10, 1992	Third Council Directive on the coordination of laws, regulations, and administrative provisions relating to direct life assurance and amending the First Council Directive of March 5, 1979, and the Second Council Directive of November 8, 1990	To be fully implemented by nine member states by July 1994; Portugal and Spain by January 1996; and Greece by January 1999
Insurance Contracts (proposed but not yet adopted)	Proposal for a Council Directive on the coordination of laws, regulations, and administrative provisions relating to insurance contracts and amendments thereto	Proposed in 1979; amended in 1980; no further action contemplated by EC Commission
Compulsory Winding-up of Direct Insurance Undertaking (proposed but not yet adopted)	Proposal for a Council Directive on the coordination of laws, regulations, and administrative provisions relating to the compulsory winding-up of direct insurance undertakings	Proposed in 1987; amended in 1989; not yet adopted as of December 31, 1992

Legend:
EEC = European Economic Community

Objectives, Scope, and Methodology

As the Chairman of the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce requested, our objectives for this review were to

- describe the framework of insurance regulation developed by the EC to create a single insurance market among its 12 member states and
- identify regulatory issues concerning the development and implementation of this framework.

To accomplish our objectives, we did the following:

- We reviewed existing literature on the EC, its single market program, and its framework of insurance regulation.
- We reviewed the legislation adopted by the EC to create its framework of insurance regulation. We focused on those pieces of legislation that implement the key provisions of the EC framework of insurance regulation.
- We met with officials of the EC Commission's Insurance Division to discuss issues concerning the EC framework of insurance regulation. In addition, we discussed the results of our review with these officials.
- We interviewed insurance regulators, insurance supervisors, insurance industry representatives, and other insurance industry experts in France, Germany, Italy, and the U.K. These four countries represent the four largest insurance markets within the EC and reflect a variety of regulatory traditions. Approximately four-fifths (82.4 percent) of all insurance premiums collected in the EC in 1990 came from these member states.
- While doing fieldwork in France, we also met with representatives of the Organization for Economic Cooperation and Development (OECD); the European Committee of Insurers; and national delegations of insurance regulators and supervisors representing other EC member states (Belgium, the Netherlands, and Spain), countries of the EFTA (Sweden and Switzerland), and the United States at a meeting of the OECD's Insurance Committee.

Comments From the Commission of the European Communities

COMMISSION
OF THE EUROPEAN
COMMUNITIES

DIRECTORATE-GENERAL
FINANCIAL INSTITUTIONS AND
COMPANY LAW

Insurance & Pension
Funds Division

Brussels,
SS/sb/N/93.03.160
XV/D/960

Mr James L. Bothwell
Director of Financial Institutions and Market Issues
U.S. GENERAL ACCOUNTING OFFICE
General Government Division
Washington DC 20548

Dear Mr Bothwell,

The Commission is very grateful for being given the opportunity to present its views on the GAO report on the European Community 'Regulatory Issues In Creating a Single Insurance Market' which we hope will help further the understanding of the efforts undertaken by the EC in recent years to create an internal market for financial services.

See comment 1.

Please find annexed a number of detailed comments on the report. By way of a general comment, however, we do not find the report entirely successful in explaining the EC's system as set up by the Community's insurance directives.

See pages 5 and 6.

First, there is, we found, an implicit premise running through the report that anything short of totally harmonised standards at EC level does or will create 'uncertainties' and problems. As you will know, the original Community's approach for creating the single market has been by detailed harmonization of Member States legislation. On the basis of the Commission's White Paper on the Achievement of an Internal Market, Member States decided to change this. To speed up the integration process, more emphasis was laid on mutual recognition of Member States' legislation enabled by a minimum level of harmonization.

See comment 2.

This approach has also been followed for insurance. It should however be borne in mind that a minimum level certainly is not equivalent to a minimal level. Traditionally prudential standards are very high in the Community as can be seen from the very limited number of failures in the past. The standards set by the EC directives which after lengthy and detailed negotiations were adopted unanimously by all Member States reflect these very high standards. Where, apparently, in the course of the interviews uncertainties were voiced, it would seem therefore that these do not reflect doubts about the prudential level of the standards set.

As the directive introduces at the same time important and unparalelled measures of liberalisation of traditionally strong regulated markets – hitherto characterized by strict ex ante control of premiums and policies – through a switch towards ex post control, it is only logical that regulators and market participants in those countries voice some concern in view of the changes in the regulatory and competitive environment. I should also point out that the prudential regime introduced by the Directives has been in place for a long time in a number of member States and that others were already contemplating or introducing it before the directives were adopted.

It is evident that a system as the one agreed within the Community requires a high degree of cooperation between the supervisory authorities of the Member States to ensure its good functioning. Existing mechanisms for cooperation through the Conference of Supervisory Authorities and the protocols annexed to the Insurance directives have therefore in 1992 been completed by the creation of the Insurance Committee. This has already proven to be an effective forum for discussing and advising on a wide set of regulatory issues. Insofar as regulatory uncertainties may need to be solved, the existing institutional framework is available to deal with them adequately. Furthermore a programme has been set up for the exchange of officials between supervisory authorities.

I am convinced therefore that the Community has succeeded in bringing about an important liberalisation of its insurance markets, allowing any insurance undertaking incorporated within the EC to operate freely in our internal market on the basis of a single licence, but operating within a regulatory framework of high prudential standards and providing the supervisory authorities with all the instruments necessary to effectively and adequately protect policyholders and third parties.

I am hopeful that our general remarks and those of detail given in the annex will find their reflection in the final report and I am, of course, at your disposal for further information should you consider this necessary.

Once again I wish to express our gratitude for having been given this opportunity to express our comments on the report.

Yours sincerely,

Jean-Pierre Fèvre
Director General a.i.

ANNEX

Page by page comments by the European Commission on the GAO's report on the European Community entitled 'Regulatory issues in creating a Single Insurance Market'

General comments

See page 6.

1. Referring to the general comment in the preceding letter the focus on what are called "remaining uncertainties" gives a biased view of the EC-regulatory system as it will be applied as of July 1994. In particular, the important effort to deregulate insurance markets, creating new opportunities for the industry, including companies from non EC-countries, receives practically no attention although this effort is unparalelled by any of our trading partners. Instead the report concentrates on perceived "uncertainties" of the EC-system. In its own words, "although the EC has already adopted the key elements of its framework of insurance regulation as envisioned under the Single Market programme, three groups of regulatory issues remain concerning the development of the framework". The first group of issues is called issues which "EC officials acknowledge need to be addressed", the second group is called "continuing regulatory differences among the Member States" and the third group is called issues which "reflect uncertainties over elements of the EC framework of insurance regulations which have been adopted but which have not been fully implemented". The Commission does not accept the conclusions of the report for the following reasons:

See comment 3.

2. Concerning the first group of issues, the report leaves the impression that these are problems which still need to be addressed. However, in reality, these problems either already have been addressed or are on their way to being solved. No regulatory system in the world, including the EC one, can claim to be perfect and there will always be new problems emerging for regulatory systems to deal with. The first group of issues are such problems, following, as it were, logically from market developments rather than structural flaws in the framework.

Concerning the second group of issues, "continuing regulatory differences among the Member States", it is stated that 'although EC officials contend that these areas do not require harmonization, most insurance industry representatives and market analysts we interviewed in the EC believe that the absence of harmonization of these areas could undermine certain objectives of the Single Insurance market'. This is not sufficient. Although there is obviously an ongoing debate within the EC on these subject-matters, they can not be grouped under the same heading but must be dealt with individually and with much more nuance and detail if the chapter is going to make any real sense.

See comment 4.

The report states, for example, that "while insurance premiums in the United Kingdom are not taxed, premium taxes in France range from 7 to 30% depending on the type of risk insured". This information is meaningless unless an explanation is given of the principle of "territoriality" which means that any French company operating in the United Kingdom would of course operate on competitive conditions similar to those of the local companies. The report goes on to state that "by subjecting all policies in a Member State to premium taxes, the EC prevents an insurance company based in another Member State from offering premiums with lower taxes". Indeed, but it is not demonstrated that this presents a problem. Is there a real problem ? We are not aware of any, yet, but developments in other markets – as e.g. the internal market in manufactured goods in the U.S. – show that despite differences in sales taxes such as those between the individual U.S. states this need not be a major concern.

See comment 5.

The chapter on contract law is quite simply insufficient and neither succeeds in representing the EC's position nor those of its critics. The chapter on asset valuation methods broadly claims that the EC rules "allow insurance companies of different Member States to assess the value of such assets and liabilities using different standards of prudence". This is incorrect. Prudential standards have been harmonized, though the methods applied may (continue to) be different.

See comment 6.

See comment 7.

See comment 8.

See comment 9.
See comment 32.
See comment 10.

The third group of issues "uncertainties about some features of the EC's framework of insurance regulations" is speculative and leaves the impression that everything is still in a flux at EC regulatory level; the 'uncertainties' voiced particularly reflect the recognition of the need for adaptation of traditional rules and practices. The concerns about Member States' sovereignty are simply based on a misunderstanding, as are the references to the lack of a precise defintion of insolvency. Furthermore, by omitting to deal in detail with the concept of "general good", a concept which is laid down in the directives and which has been defined by the European Court of Justice in numerous Court cases, the report fails to come to terms with a key element in the EC's balance between Community legislation and Member States' residual competences.

<u>Detailed comments</u>

See comment 11.

<u>Page 1 - last line</u>
The EC's single market programme was launched in 1985 and not 1986.

See comment 12.

<u>Page 1 -second footnote</u>
Switzerland's rejection of the EEA agreement will not delay the EEA's <u>establishment</u> but <u>postpone</u> the time of its entering into force by 6 months.

See comment 13.

<u>Page 5 - first full alinea</u>
Page 6, top: it is difficult to evaluate the statements of unidentified spokesmen.

See comment 14.

<u>Page 7 - first alinea</u>
The European Court of Justice is somewhat curiously linked up with the insurance Committee of the EC although they have totally different

competences and objectives. Why is no reference given to Treaty-given task of the Commission to monitor the correct implementation of EC-legislation by Member States?

See comment 15.

Page 7 - third paragraph

It is stated that officials from the EC "generally agreed with the information presented". This is the case subject to these comments and the general comments in the preceding letter.

See comment 16.

Page 15 - second indent

It is stated that "we were unable to analyze solvency trends among insurance companies in the EC. Member State insurance supervisors could not provide us with the quantitative financial data". This may leave the impression that such data do not exist. The authorities are more likely to have been bound by professional secrecy rules.

See comment 17.

Where it is said that EC-officials acknowledge the need to reassess prudential standards, the context of those remarks has been omitted. It suggests we think they are below standards. What we have said, however, is that given the changes in the competitive environment, which will come about as a consequence of the liberalization process, traditional control practices on rules merit to be examined, which should be done regularly, anyway as markets develop and change.

See comment 18.

Page 17 - footnote

Replace "standardize" in the footnote by "detailed harmonization of Member States' legislation". The discretion is in the methods applied, not in the objective as level of standard.

See comment 19.

Page 22 - last sentence

The reference to investment services is incorrect: it has not yet been formally adopted by Council.

See comment 10.

Page 23 - last sentence

Gives short thrift to the concept of "general good". The statement as it stands is incorrect and needs to be complemented by the criteria laid down by the jurisprudence of the European Court of Justice for applying the general good.

See comment 20.

Page 30 - first alinea, last sentence

The directive on winding up of is under negotiation in Council at the present time.

See comment 21.

Page 33 - first line

No decision has yet been taken on the merits or demerits of supervision on a consolidated basis or possible alternative approaches.

Page 38, las full para

Standards of prudence have been harmonized or mutually recognized, it is again the methods which may be different.

See comment 7.

See comment 22.

Page 39 - last alinea

There is no common format for the annual reports to supervisors.

Page 40 - first alinea

See comment 23.

The 'fit and proper' test is part of the framework Directives also for shareholders. Specific anti-fraud measures at present are left to the individual Member States. This is not an issue which has led to discussion at EC-levels with a view to take measures at EC-level.

See comment 24.

Page 44 - last alinea

This is a misrepresentation of the EC's directives which do oblige the Member States to cooperate and in e.g. Article 16 of the Third Non-Life Directive establishes a framework for this cooperation including among other things respect for professional secrecy rules. The statement (page 45, 3rd alinea) that "at least two insurance supervisors we interviewed indicated that they would not guarantee to their consumers the soundness of policies issued by insurance companies based in other Member States" is misleading. Host state supervisors are not in the business of guaranteeing the financial soundness of products to the consumers but under the EC system are bound by the directives which lay down the equivalence of Member States' regulatory systems based on EC-wide common regulatory standards.

Page 45 - Second alinea

See comment 25.

The Insurance Committee of the EEC has been functioning for more than a year: it already does provide a forum for information exchanges etc.

Page 47 - footnote 14

See comment 26.

Is not in conformity with the provisions of the framework directives: it is home state supervisors who take action.

Page 48, first alinea

See comment 27.

A precise definition of insolvency is not an issue in the context of the winding up directive. It relates to the discussion on financial conglomerates. Whether a Convention of bankruptcy will be adopted sooner or later is less relevant in view of the separate proposal for insurance companies.

Page 49 - last sentence

See comment 28.

Obviously any kind of final assessment of the EC's system as set up by the framework directives can only be "final" after the system has worked for a number of years. The directives will not enter into force until July 1, 1994. However, the report, while emphasizing the "uncertainty" of the implementation of the framework directives by the Member States of which the Commission sees no signs, ignores the fact that the market in Europe already seems to be anticipating the opening up of the market as witnessed by the large number of insurance companies having notified their intention of doing business in other EC Member States, and the increase in (cross-border) merger activities.

See comment 29.

Page 50

See comment 30.

To document the lack of progress until 1985, the report ought not to have to rely on "various industry analysts", but would have done well to mention two studies for the development of the EC, i.e. the so-called Cecchini

Report of 1988, volume 12 of which deals with 'The Cost of Non-Europe in Financial Services', or "The Economics of 1992", n° 35 of European Economy published in March 1988.

Page 51 - first paragraph

See comment 31.

Page 51 - second alinea
"Unanimity was effectively required". This refers to the so-called "Luxembourg agreement" I suppose. Qualified majority voting was already introduced by the Treaty of Rome/

See comment 32.

Page 51 - last alinea
Fails to explain the case of the new EC approach to harmonization i.e. mutual recognition of supervisory systems based on agreed common prudential standards, which in turn allows for a single passport and home-country control.

See comment 33.

Page 52 - first paragraph
Calling the Commission "representative of the various Member States" is a somewhat cavalier way of interpreting Art. 157 of the Treaty of Rome according to which the Members of the Commission "shall neither seek nor take instructions from any government". It is, of course, the Council of Ministers which represent the interests of Member States.

See comment 34.

Page 52 - third paragraph
Why is the European Parliament 'more populist in nature'. Its powers to make amendments are limited and should be explained.

See comment 35.

Page 52
Why are the Economic and Social Committee and the Court of Auditors not mentioned ?

See comment 36.

Page 53
The Chapter of the legislative process is not quite correct and needs to be elaborated and amended according to the new Article 149 of the Rome Treaty.

The following are GAO's comments on the letter from the Commission of the European Communities received on March 24, 1993.

GAO Comments

1. We met with Commission officials on September 23, 1992, to discuss a draft of our preliminary observations. Subsequently, on January 18, 1993, we gave the Commission a draft of our report, incorporating the Commission's comments from our meeting in September. We also invited the Commission to provide a letter expressing its views on the draft, which would be incorporated into the final report. When we received the Commission's letter on March 24, 1993, we had already revised the draft to reflect many of the Commission's suggested technical corrections in the "detailed annex" attached to the letter.

2. The report does not equate the words "minimum" and "minimal" with respect to the EC's prudential standards for insurance companies. As we describe on page 12 and in appendix IV, pages 35 to 37, the EC's prudential standards are minimum standards of financial soundness for insurance companies. Member states may impose more stringent prudential standards on their domestically based companies. Nevertheless, we believe that the EC's standards merit discussion in the report for various reasons. First, the design and adequacy of the prudential standards play a central role in determining whether the financial soundness of insurance companies will be maintained within the EC framework. On page 1 of its letter (p. 47), for example, the Commission links these "very high" prudential standards to the "very limited number of [insurance company] failures in the past." As we report on page 27, some market analysts would attribute this record to other factors as well, including relatively closed markets and strict controls over premiums and policy conditions in some member states. Second, as discussed on pages 16 and 17 and acknowledged by EC officials, member states already tend to require higher prudential standards from their insurance companies than does the EC. Furthermore, as stated on page 16, the EC itself will require a reassessment of its current solvency margin requirements in the near future. Third, member states had opposing views on the prudential standards in the past. As the Commission states in its letter, member states reached agreement on the standards only "after lengthy and detailed negotiations." Finally, although the "prudential regime introduced by the [EC] Directives has been in place for a long time in a number of member states" such as the U.K., other member states, including France, Germany, and Italy, whose markets account for over half the total EC insurance market, must introduce relatively major changes to their national

regulatory systems as a result of the EC framework. Moreover, the EC's prudential standards have not yet been tested in the single EC insurance market that is expected to emerge after the EC's framework is implemented in 1994.

3. Our discussion of the first group of issues on pages 16 to 18 identifies regulatory areas that EC officials acknowledged need to be further addressed and describes measures already taken and being considered by the EC to address each area. Consequently, this discussion is in accordance with, rather than in opposition to, the Commission's acknowledgment that "no regulatory system in the world, including the EC one, can claim to be perfect and there will always be new problems emerging for regulatory systems to deal with." In addition, we did not attempt to discern whether these issues stem from structural flaws in the EC's framework or from market developments. Regardless of the origin of these issues, the EC is still considering additional regulatory measures to address them.

4. We disagree that the second group of issues "cannot be grouped under the same heading but must be dealt with individually and with much more nuance and detail." First, each of these issues involves regulatory areas that continue to differ among the member states and that the EC does not intend to harmonize. Second, the report does deal with each issue individually on pages 18 to 22. Instead of presenting extensive details, we attempted to include only enough information to allow a nontechnical reader to gain an appreciation of the regulatory issues involved.

5. We disagree that the report's description of the variation in insurance premium taxes among the member states is "meaningless" without further explanation. However, we have modified the report to clarify the description and address the EC's concerns. According to several analysts, including the former head of the EC Commission's Insurance Division, the wide variation in member state tax policies regarding premium and insurance companies, while not always discriminatory, may distort competition. Such variation amplifies the impact of the discriminatory practice among some member states of granting tax relief for certain premium payments only to domestically based insurance companies. As described on page 19 of the report, the EC Commission unsuccessfully challenged a Belgian tax law that prevented Belgian taxpayers from deducting premiums paid for certain life insurance policies by companies based in other member states. In this case, however, the European Court of Justice ruled that, in the absence of tax harmonization in the EC, the

Belgian law was necessary to protect the integrity of Belgium's fiscal system.

6. The Commission does not specify how the section on contract law "is quite simply insufficient and neither succeeds in representing the EC's position nor those of its critics." We believe that the section accurately describes that contract laws continue to vary among the member states and that the EC generally subjects an insurance policy to the laws of the member state in which the policyholder resides. The report does not identify any criticisms against the EC's approach to this issue. Page 20 of the report includes the EC's stated position that adequate provisions exist in its framework of insurance regulation for the member states to protect consumers.

7. We have modified this section of the report to indicate that, under the EC's framework, insurance companies of different member states may assess the values of the same types of assets and liabilities according to different interpretations of the EC's standards of prudence.

8. We disagree that the third group of issues is speculative and that the report "leaves the impression that everything is still in a flux at the EC regulatory level." First, we did not identify these issues based on speculation. Rather, we identified them from discussions with the member state regulators and supervisors who will be required to implement the EC's framework of insurance regulation. Second, the report does not indicate that the EC's regulatory framework is still in a state of flux. In fact, page 16 states that "the EC has already adopted all the directives that it considers essential for creating a single insurance market . . . ." On the other hand, insurance regulators and supervisors in some member states, including France, Germany, and Italy, are likely to experience considerable changes, since they will be required to adapt their traditional regulatory and supervisory systems to the EC's framework by 1994. Finally, for each issue in the third group, the report also describes measures that member states and the EC are taking to address the various uncertainties.

9. The Commission does not specify how the report misinterprets concerns about member state sovereignty, which the report mentions once and attributes to insurance industry observers on page 25.

10. We disagree that the report does not "deal in detail with the concept of the 'general good.'" Page 26 of the report describes this important concept in some detail as well as previous rulings by the European Court of Justice

on the interpretation of the concept. Host state provisions defining the application of this concept must meet the criteria established by the court.

11. We modified the draft to indicate that the EC's single market program was launched in 1985.

12. We have modified the report to indicate that Switzerland's rejection of the EEA agreement will postpone the agreement's entering into force by 6 months.

13. For readability, we sometimes attribute the views and opinions of others in a general sense, rather than to specific individuals. In this case, we attributed an observation to various "insurance industry representatives and market analysts," as we do elsewhere in the report. However, to address the Commission's concern, we have modified the report to indicate that one of these individuals was the former head of the Commission's Insurance Division.

14. We disagree that the "European Court of Justice is somewhat curiously linked up with the insurance committee of the EC" in this section. The paragraph summarizes various regulatory and supervisory mechanisms by which the EC and various member states are addressing some of the uncertainties in the third group of issues. Among the mechanisms described are two EC institutions: the Insurance Advisory Committee, which helps to foster cooperation and information sharing among member state insurance supervisors, and the European Court of Justice, which helps to resolve conflicts over the interpretation of EC criteria for supervisory intervention. The report does not indicate that these two institutions have the same "competences and objectives." It describes each of them separately and in further detail on pages 24 to 25 and 30. Finally, the report does not discuss the Commission's role with respect to the implementation of EC legislation by the member states in this section, since we did not identify this issue as a regulatory uncertainty. However, the report does mention this role on page 29.

15. We have included the Commission's letter, general comments, and detailed comments in the report.

16. We have deleted this section from the report.

17. We disagree that the report omits the context within which EC officials acknowledged the need to reassess prudential standards. Page 16 of the

report specifically states that "EC officials intend to review the appropriateness of the current minimum prudential standards in light of changes in insurance markets since the standards were first established in the 1970s." Furthermore, as elaborated in comment 2, we believe that the EC's prudential standards merit discussion, given their important role in maintaining the financial soundness of insurance companies in the EC's framework of insurance regulation.

18. We have clarified the footnote to indicate that the EC previously attempted to achieve greater uniformity of standards among member states through detailed legislative harmonization.

19. We have modified the sentence to indicate that the EC has adopted a common position for the adoption of a similar framework for investment services by 1996.

20. We have modified this sentence to indicate that the Council of Ministers is now considering the proposed directive.

21. The report does not indicate that the EC has decided on the "merits or demerits of supervision on a consolidated basis or possible alternative approaches." Pages 17 and 18 describe the EC's approach to the supervision of financial conglomerates as articulated on October 29, 1992, by Geoffrey Fitchew, Director General of the EC's Directorate General for Financial Institutions and Company Law. However, we have revised this section to clarify that the EC has not yet adopted rules on consolidated supervision.

22. We have deleted references to a protocol by the Conference of the Insurance Supervisory Services of EC Countries providing for a common format for supervisory returns among member states.

23. Page 22 of the report already states that the EC has adopted similar "fit and proper" provisions for major shareholders. It also makes clear that the EC has left the responsibility for antifraud measures to the member states. However, we have modified the report to indicate that the issue has not been discussed at an EC level.

24. We disagree that this section misrepresents the EC's directives on member state cooperation. First, page 24 explicitly states that "the EC requires the EC Commission and member state authorities to 'collaborate closely' in supervising insurance companies within the EC" and that

"recently adopted directives also allow . . . member state authorities to exchange confidential information and to conclude bilateral agreements for such information exchanges." Second, we question the Commission's assertion that "host state supervisors are not in the business of guaranteeing the financial soundness of products to the consumers . . . ." Although the EC framework assigns home state supervisors the responsibility for ensuring the financial soundness of their insurance companies throughout the EC, it nevertheless allows host state supervisors to act against companies based in other member states specifically to protect consumers.

25. We have modified the tense of the sentence to indicate that the Committee is already providing a forum for information exchanges and other means of cooperation among member states.

26. We have amended the footnote to indicate that, once the framework directives are fully implemented, home state supervisors will also assume responsibility for taking actions against insurance companies with insufficient technical reserves.

27. Although the issue of defining "insolvency" may also relate to discussions about financial conglomerates, we believe that the issue is still very relevant to the EC's proposed directive on insolvent insurance companies and the disposition of their assets. As stated on pages 26 and 27, the EC provides relatively general criteria for supervisory action in this proposed directive, in contrast to the those it has specified regarding prudential standards. We have found in our work on U.S. state-based insurance regulation that the lack of a clear regulatory definition of insolvency has at times delayed regulatory action to the detriment of the insolvent companies' policyholders.

28. We disagree that the report emphasizes the "uncertainty" of the implementation of the EC's "framework directives." The report links the "uncertainties" associated with the third group of issues to the effects of the EC framework's implementation, rather than to the implementation itself. In addition, we also describe positive measures being taken by the EC and member states to address each uncertainty (pp. 4 to 5 and 22 to 27) as well as the accomplishments of the EC in creating a regulatory framework for a single insurance market (pp. 12, 14, and 15). While "the Commission sees no signs" of the uncertainties we identified, insurance regulators, supervisors, companies, and market analysts in the member

states we visited readily discussed these issues during our conversations with them.

29. As discussed on page 6, the report focuses on regulatory issues rather than market developments. However, we have included the Commission's observations regarding the response of insurance companies to the anticipated single insurance market on page 13 of the report.

30. The report does refer to one of these studies. On page 13, we state that "according to a study commissioned by the EC [the Cecchini report], market integration within the EC's three financial services sectors—banking, securities, and insurance—could eventually result in economic gains of approximately European Currency Unit (ECU) 22 billion ($26 billion)."

31. The report does not state that "unanimity was effectively required," as the Commission quotes. However, we have modified the report to clarify that, although already in existence, qualified majority voting was extended to most proposals associated with the single market program.

32. We disagree that the report fails to explain the EC's new approach to harmonization. Pages 12 to 14 describe in some detail the mutual recognition of supervisory systems, common prudential standards, and the single passport/home country control provisions of the EC's regulatory framework.

33. We have modified the report to clarify that the composition, rather than the interests, of the Commission is representative of the member states. On page 29, we distinguish between the role of the Commission and that of the Council of Ministers, which "represents the views of the individual member states . . . ."

34. We have deleted this sentence from the report and have modified the description of the European Parliament's ability to make legislative amendments.

35. Our overview of EC institutions only describes the four main institutions involved in the EC legislative process. According to A Guide to the European Community, published by the EC Delegation to the United States, these four EC organizations form a quadripartite institutional system for governing the EC. In contrast, this publication describes the Economic and Social Committee (which our report refers to in footnote 2

on page 30) as a "consultative body" to the Commission and the Council, and indicates that the Court of Auditors primarily "supervises Community expenditures."

36. We have modified the section on the EC legislative process based on subsequent discussions with the Commission.

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